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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-332

F. EBERSTADT & CO. INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER,

Petitioners,

vs.

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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Respondent Susan Tannenbaum submits this brief (a) in opposition to the petition for a writ of certiorari herein to the United States Court of Appeals for the Second Circuit and (b) in response to the brief of the Investment Company Institute as *amicus curiae* in support of the petition.

Questions Presented

1. Did the proxy statements issued to shareholders of Chemical Fund, Inc., for the annual meetings in the years 1967 through 1971 fail to disclose material facts in violation of the proxy rules promulgated by the Securities and Exchange Commission pursuant to the Investment Company Act of 1940?

2. Was the non-disclosure issue fairly presented in the District Court?

Statutes Involved

In addition to the statutes and rules reproduced in the petition, there is involved Section 15(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-15(a), which is reproduced in the appendix to this brief.

Statement of the Case

This stockholders' derivative action was commenced in May 1971 by respondent Susan Tannenbaum on behalf of respondent Chemical Fund, Inc., a registered investment company (mutual fund). The action had its genesis in portfolio brokerage practices which were common to the mutual fund industry during the 1960's, prior to the advent of negotiated commission rates on the nation's securities exchanges. Plaintiff sought damages on behalf of the Fund against petitioners (the manager of the Fund and certain controlling persons) by reason of:

> (1) petitioners' failure to cause the Fund to recapture portfolio brokerage commissions for the benefit of the Fund; and

> (2) the failure to disclose material aspects of the Fund's brokerage practices in proxy statements and other documents issued to Fund shareholders.

The action was tried without a jury in the District Court solely on the question of liability. On August 1, 1975, the District Court entered judgment dismissing the action.

On appeal, the Court of Appeals rejected plaintiff's contentions (a) that the Fund's manager and interested directors had a duty to recapture excess commissions for the Fund's benefit under the Fund's charter and its management and distribution agreements; (b) that the failure to recapture violated Section 36 of the Investment Company Act, 15 U.S.C. § 80a-35, and (c) that the manager and interested directors had violated their duty of disclosure to the independent directors.

The Court of Appeals concluded, however, that the proxy statements distributed to the Fund's shareholders for the years 1967 through 1971 violated the disclosure provisions of the federal securities laws, because they failed, among other things, to advise the shareholders, who had an express statutory right under Section 15(a) of the Investment Company Act to approve, terminate or renegotiate the Fund's management contract: (a) that substantial portions of the Fund's brokerage commissions were recapturable for the Fund's benefit and (b) that the Fund's board—for reasons never disclosed—had decided to forego recapture (A70-71).*

The Court of Appeals remanded the action to the District Court to determine what damages, if any, were

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* References preceded by "A" are to the appendix to the petition which contains the opinions of the Court of Appeals and of the District Court.

caused to the Fund by the proxy statements found to be in violation of the proxy rules (A74).

In seeking rehearing in the Court of Appeals, petitioners did not urge that that court had overlooked or misapprehended any controlling point of law or issue of fact, nor did they suggest that the issue for which they sought rehearing had not been thoroughly briefed and argued on appeal. The focus of their petition was, in fact, decidedly away from the merits of the issue on which plaintiff had prevailed—namely, the adequacy of the disclosure in the Fund's proxy statements during the years 1967 through 1971. They relied instead on a presumed "disaster for the mutual fund industry" which, it was claimed, would result from the court's decision and on alleged procedural infirmities in the District Court. The same points are again pressed here.

Reasons for Denying the Writ

The reasons urged by petitioners in support of the writ are, we submit, misleading and incomplete. Neither the petition nor the amicus brief directly addresses itself to the cogent analysis found in the opinion of the Court of Appeals regarding the adequacy of disclosure in the Fund's proxy statements during the years 1967 through 1971 (A61-74). Applying the test formulated by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S. Ct. 2126 (1976), for determining the materiality of omissions in proxy statements, the Court of Appeals found that the omissions regarding the availability of, and the decision to forego, recapture were material as a matter of law (A72-73).

Petitioners do not attack the consistency or logic of the Court of Appeals' reasoning, nor do they point to any

overlooked or misapprehended precedent. The thrust of their argument is that the Court of Appeals should have been more alert to the "policy implications" of its decision (petition, p. 11)—considerations which, in our view, should more properly be raised in a legislative forum. We nonetheless respond briefly to the contentions made in support of the petition.

A. The contention that the Court of Appeals' decision "spells disaster" for the mutual fund industry.

Petitioners urge at page 9 of the petition that, if the decision below stands, "most mutual fund proxy statements in recent years will be deemed false and misleading, most mutual fund management contracts are in limbo and mutual fund managers and directors stand exposed to liability . . ." We find it difficult to respond to these contentions, because they are addressed to matters wholly outside the record in this case, are supported by factual assertions that seem to be dubious at best and, in any event, are irrelevant.

First, because of the advent of negotiated brokerage rates, recapture no longer has the significance for mutual funds that it once had.* Through competition and negotiation, "excess" commission dollars have been eliminated,

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* In its brief *amicus curiae* in support of rehearing in the court below the Investment Company Institute (ICI) stated (pp. 9-10):

> "Due to the establishment of competitive rates of brokerage commissions, mutual funds basically are no longer faced with the decision of whether to recapture. *Thus, the recapture issue has for practical purposes become moot and the Court's requirement of the disclosure at issue will not be a guide to future conduct.*" (Emphasis added.)

(Footnote continued on following page)

and commission charges have been driven down to the point that recapture is not practicable. Furthermore, most avenues of recapture have been closed off in recent years, first through administrative action and later by legislation. In February 1972 the SEC issued its Policy Statement on the Future Structure of the Securities Markets. The SEC, having forced the abolition of give-ups in December 1968, stated in its report that reciprocal practices must also be terminated. In response, the NASD proposed in 1972 a rule to abolish reciprocals, which became effective in July 1973. In 1973, the SEC promulgated Rule 19b-2, which greatly circumscribed the ability of mutual funds to obtain reductions of commissions through institutional membership on the exchanges. These developments were capped by the adoption of the Securities Acts Amendments of 1975, which eliminated transactions for one's own account or that of an associate. *See Fogel* v. *Chestnutt,* 533 F.2d 731, 740-744 (2d Cir. 1975), cert. denied, 429 U.S. 824, 97 S. Ct. 77 (1976). Pursuant to Rule 19b-3, effective May 1, 1975, fixed commission rates were prohibited.

The virtual elimination of recapture over the last several years makes somewhat puzzling the notion that the Court of Appeals' decision, if permitted to stand, "spells disaster" for the mutual fund industry (petition, p. 8) or will "stimulate a new wave of derivative mutual fund litigation" (petition, p. 9). If, as the ICI asserted in its brief in the Court of Appeals (see footnote, p. 5, *supra*), recapture is no longer a viable technique (in stark con-

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(Footnote continued from preceding page)

Elsewhere in its brief the ICI described recapture as being ". . . obsolete in light of the advent of competitive brokerage rates" (p. 2) and a "no longer relevant practice" (p. 9). All references to the fact that the issue of recapture is now moot have been deleted from its brief in this Court.

trast to the situation that prevailed in the industry prior to 1972), there could hardly have been a disclosure issue in the last several years so far as a fund's proxy statements were concerned. The alleged impact of the decision below on fund management contracts is, we submit, chimerical.

Although the ICI states in its brief (p. 13) that a "new round of litigation could be triggered" by the decision of the Court of Appeals, we do not know of any other lawsuit, initiated before or since that decision, which alleges proxy violations relating to recapture; nor have petitioners or the ICI pointed to any such case.

The suggestion that the decision below will subject members of the industry to horrendous damage claims is equally unsound. Commencing with the landmark *Moses* v. *Burgin* decision in June 1971*, mutual funds *did* begin to disclose in their proxy statements (a) the possibility of recapture and (b) the determination of the fund's board with respect to recapture. (Indeed, as explained at length in the decision below (A64-66), that is precisely what occurred in the case of Chemical Fund, starting with its 1972 proxy statement.) Although the amicus asserts (p. 6) that to "the extent we have been able to determine", fund proxy statements generally did not contain these disclosures, its brief is significantly vague as to date. The absence of such disclosures in current proxy statements undoubtedly reflects the fact that recapture is no longer a viable alternative.** The absence of such disclosures in proxy statements issued prior to the *Moses* decision is

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* *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir. 1971), cert. denied sub. nom. *Johnson* v. *Moses,* 404 U.S. 994, 92 S. Ct. 532 (1971).

** See footnote, p. 5, *supra.*

also not surprising, since it was evidently not the practice (as shown by *Moses, Fogel* and settlements achieved in a substantial number of similar lawsuits) for fund managers to bring to the attention of the independent directors (much less, the shareholders) the fact that recapture of commissions for the fund's benefit was a distinct possibility. We think it extremely unlikely, however, that sophisticated fund managers, confronted with the clear threat of litigation following the *Moses* decision, did not fully disclose in proxy statements the policy of the fund with respect to recapture so long as that technique remained viable. In short, the potential for new litigation arising from the Court of Appeals' decision (if it exists at all) is in all probability limited to proxy statements issued in 1971 and prior years and circumscribed by applicable statutes of limitations.

Some comment also seems appropriate on the applicable measure of damages in cases where, as here, fund proxy statements are found not to have made proper disclosures. While we take no position at this time regarding the appropriate measure of damages,* the suggestion that the manager might be required to pay the Fund damages in an amount equal to the entire management fee seems somewhat fanciful. In *Lutz* v. *Boas,* 171 A.2d 381 (Del. Ch. 1961), Chancellor Seitz, confronted with the same issue, rejected the argument that the defendants should be compelled to repay the entire management fee and adopted a measure of recovery based on equitable principles.

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* As the Court of Appeals noted in its decision (A7), the action was tried in the District Court on the issue of liability only. In remanding to the District Court, the court expressly left open the issue of damages (A74).

B. The contention that the SEC "rejected" in 1972 any requirement that the possibility of recapture be disclosed.

Both the petition and the amicus brief place heavy emphasis on the notion that the SEC "rejected" any requirement that fund proxy statements disclose the possibility of recapture for the benefit of the fund when it adopted new guidelines for the preparation of fund prospectuses in 1972. In doing so, they:

(a) ignore the fact that both the proposed 1969 guidelines (Release No. 40-5634) and the 1972 guidelines (Release No. 40-7220) are directed only to prospectuses, not proxy statements;

(b) ignore the fact that prospective purchasers of fund shares (as opposed to existing shareholders) are not authorized, or asked, to approve or reject the fund's management contract and by implication the fund's policy toward recapture;

(c) ignore the fact that the 1969 guidelines were proposed in light of portfolio practices that were tolerated at the time but, as a result of the *Moses* decision and the changing attitude of the SEC, had largely been proscribed by the time the 1972 guidelines were issued;

(d) ignore the following statement in the 1972 guidelines (p. 2):

> ". . . the public is cautioned that the opinions expressed in this release are not, and do not purport to be, an official expression of the Commission's views."

In short, the change in the guidelines for fund prospectuses from 1969 to 1972 hardly constitutes an authoritative declaration by the Commission that a fund need not disclose in its proxy statement, when asking shareholders to consider and vote on the management contract, the fact that management has considered and rejected recapture.

Similarly, we think that the petition and amicus brief vastly overstate the significance of the fact that the Fund's proxy statements, like those of all other mutual funds, were routinely filed with the SEC. As noted in the decision below (A18-19), the SEC was admittedly less than consistent in its approach to recapture and the overriding problem of excess commissions. In light of the SEC's own uncertainty, it is not surprising that it did not promulgate rules or policies setting forth the precise kinds of disclosures required in fund proxy statements in all circumstances. In any event, under Section 15(a) of the Investment Company Act, the shareholders of a fund have been given significant voting powers with respect to the approval or rejection of the fund's management contract. That being so, the conclusion is inescapable that the shareholders are entitled to full disclosure of every material fact bearing on the matter under consideration, irrespective of the directors' views regarding the merits of the proposal.

C. The contention that the disclosure issue was not raised in the District Court.

Petitioners urge in their petition, as they earlier urged in the court below, that the question of the adequacy of disclosure in the Fund's proxy statements, annual and quarterly reports and prospectuses was not properly raised in the District Court. The Court of Appeals acknowledged in its opinion that such an argument had been made but rejected it (A68, fn. 34), and the same argument was rejected on petition for rehearing.*

Petitioners again make the argument that plaintiff's disclosure claims were "mere after-thoughts". We repeat our earlier rejoinder: Although neither the complaint nor the pre-trial order specifically spells out plaintiff's non-disclosure claims, they are integrally related to plaintiff's other claims; the proxy statements relied on (Exhibits 28-38) were introduced in evidence at the trial without any objection by defendants' counsel (Tr. 10-11); defense witnesses were questioned about the disclosures in those documents (Tr. 135-138, 196-199); the issues were briefed before the District Court; and the District Court specifically dealt with those issues in its opinion (A89-90).**

Additional argument is made in support of the writ on the ground that plaintiff's counsel (a) did not focus the trial court's attention on the disclosure issue in his opening statement and (b) asked only one question of defendants' witnesses regarding the disclosures (petition, p. 5).

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* In its brief *amicus curiae* in the Court of Appeals the SEC stated (p. 20, fn. 24):

> "We likewise take no position with regard to the claims *arising under the securities laws and based upon the lack of adequate disclosure of the Fund's brokerage practices to the shareholders.* This issue is primarily an evidentiary question as to the correctness of the district court's finding that that disclosure was adequate." (Emphasis added.)

** Under Rule 15(b), F.R.C.P., the District Court is authorized to conform the pleadings to the issues raised and evidence presented at the trial even after judgment.

It is respectfully submitted that all of the Fund documents in question, namely, the proxy statements and other documents issued to Fund shareholders, speak eloquently for themselves. All of these documents—prior to 1972*—are silent on the availability of recapture for the Fund's benefit, the substantial sums that could be recaptured and the decision of the Board to forego recapture. From plaintiff's perspective, little purpose would have been served at trial in asking defendants' witnesses for elaboration of the documents, and plaintiff's counsel chose not to do so. Defendants' counsel adopted the same course. More significantly, however, petitioners fail to suggest in their petition how the patent deficiencies of those documents could be remedied by any evidence introduced at a new trial.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Dated: New York, New York
September 29, 1977

Respectfully submitted,

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* The Fund's 1971 proxy statement is dated March 31, 1971. This action was commenced on May 11, 1971. The *Moses* opinion was handed down on June 23, 1971.

APPENDIX

*Section 15(a) of the Investment Company Act, 15 U.S.C. § 80a-15(a)**:

> (a) After one year from the effective date of this subchapter, it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—
>
> (1) precisely describes all compensation to be paid thereunder;
>
> (2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;
>
> (3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such regis-

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* In effect prior to December 14, 1971. Section 15(a) was amended in several respects by Pub. L. 91-547, § 8, 84 Stat. 1419, which was enacted on December 14, 1970. Pursuant to Pub. L. 91-547, § 30, the amendments became effective on December 14, 1971. None of the amendments are germane to this action.

tered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.